

Message Text

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PANCANAL

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C O N F I D E N T I A L SECTION 1 OF 2 PANAMA 7225

GUATEMALA FOR ROCAP

EO 11652: GDS

TAGS: ECON, EFIN, PN

SUBJECT: PANAMA'S RECESSION IS STRUCTURAL--A RESULT OF LOW
PRODUCTIVITY

REF: PANAMA 6462

1. THIS MESSAGE IS PART OF A CONTINUING SERIES OF MISSION
ECONOMIC STUDIES ON THE STATE OF THE PANAMANIAN ECONOMY AND
PROJECTIONS FOR ITS FUTURE.

2. SUMMARY: PANAMA'S RECESSION, WHICH DEEPENED DURING THE
FIRST HALF OF 1976, IS NEITHER CYCLICAL NOR PRIMARILY A PRODUCT
OF ECONOMIC CONDITIONS OUTSIDE PANAMA. IN OUR VIEW THE ECONOMY
IS FLOUNDERING MAINLY BECAUSE ITS HIGH COST OUTPUT IS NOT COM-
PETITIVE IN THE WORLD MARKET AND FEW OPPORTUNITIES EXIST FOR
PROFITABLE PRIVATE INVESTMENT. TO ESTABLISH A BASIS FOR RE-
NEWED SUSTAINABLE GROWTH WILL REQUIRE ACTIONS THAT LEAD TO
LOWER COSTS AND IMPROVED PRODUCTIVITY. THESE COULD INCLUDE
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EASING THE LABOR CODE, REDUCING SUBSIDIES, BOOSTING

DOMESTIC SAVINGS, AND DIRECTING RESOURCE FLOWS MORE TOWARD THE INTERNATIONAL SERVICE SECTOR WHERE PANAMA HAS NATURAL ADVANTAGES. HOWEVER, MOST SUCH ACTIONS WOULD CUT BACK SOCIAL BENEFITS GRANTED TO THE WORKING CLASSES UNDER THE "REVOLUTION", AND MIGHT NOT BE POLITICALLY ACCEPTABLE UNDER THE PRESENT GOVERNMENT. INFLOWS OF FOREIGN CAPITAL HAVE NOT BEEN GETTING AT THE CORE PROBLEM OF HIGH COSTS (LOW PRODUCTIVITY). LACK OF ACCESS TO RELEVANT CANAL ZONE SITES IS DELAYING GOP DEVELOPMENT OF INFRASTRUCTURE WHICH IS PREREQUISITE TO THE GROWTH OF VARIOUS COMMERCIAL SERVICES INDUSTRIES BY THE PANAMANIAN PRIVATE SECTOR. END SUMMARY.

3. ECONOMIC CONDITIONS IN PANAMA WORSENERED STEADILY DURING THE 1976 FIRST HALF. THERE WERE DECREASES FROM A YEAR AGO IN KEY INDICATORS--MANUFACTURING, CONSTRUCTION, EXTERNAL TRADE, UNEMPLOYMENT (INCREASE), AND SALES TO THE CANAL ZONE (SEE REFTEL). OVERALL GROWTH IS LIKELY TO BE NEAR ZERO FOR 1976.

4. FAILURE OF THE ECONOMY TO RESPOND TO A VARIETY OF STIMULANTS INDICATES THAT THE RECESSION IS MORE THAN A CYCLICAL MALADJUSTMENT. CREDIT HAS REMAINED RELATIVELY PLENTIFUL, WITH PREFERENTIAL RATES AVAILABLE FROM THE GOVERNMENT FOR BOTH AGRICULTURAL AND INDUSTRIAL PROJECTS. THERE ARE TAX SUBSIDIES FOR NEW EXPORTS, AND TAX BENEFITS FOR REINVESTED PROFITS. NO BASIC CHANGES HAVE BEEN MADE IN THE "RULES OF THE GAME" UNDER WHICH BUSINESS OPERATES, SUCH AS THE LABOR CODE OR TAX LAWS, SINCE BEFORE THE ONSET OF RECESSION. IN FACT, THE GOP IN RECENT MONTHS HAS ACTIVELY SOUGHT BY VARIOUS DIRECT MEANS TO IMPROVE THE BUSINESS CLIMATE. A LARGE BOOST IN 1975 PUBLIC SECTOR SPENDING HAD LITTLE EFFECT ON EITHER PRIVATE INVESTMENT OR AGGREGATE DEMAND.

5. ALSO, PANAMANIAN ECONOMIC PROBLEMS DO NOT SEEM TO BE CAUSED PRIMARILY BY WORLDWIDE ECONOMIC TRENDS OR WORLD TRADE. IN CONTRAST TO PANAMA'S CONTINUING DECLINE, OTHER DEVELOPING COUNTRIES (LDC'S) HAVE BEEN EXPERIENCING A QUICKENING ECONOMIC TEMPO SO FAR THIS YEAR IN RESPONSE TO

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RAPID RECOVERY BY THE INDUSTRIALIZED COUNTRIES, PLUS SOME CORRECTION OF STRUCTURAL MALADJUSTMENTS. LDC EXPORTS HAVE BEEN GENERALLY INCREASING AS PART OF THE MARKED IMPROVEMENT IN 1976 FIRST HALF WORLD TRADE (PLUS 10 PERCENT) WHILE THE VALUE OF PANAMANIAN EXPORTS REMAINED AT ITS 1975 LEVEL (EXCLUDING AN ABNORMAL DECLINE IN PETROLEUM PRODUCTS EXPORTS). CHANGES IN PANAMA'S ECONOMY ALSO DIFFERED FROM THE WORLDWIDE PATTERN BOTH DURING THE 1974-75 WORLD

RECESSION AND THE YEARS IMMEDIATELY PRECEDING IT. DESPITE SHARP 1974-75 RECESSION AMONG THE INDUSTRIALIZED COUNTRIES (ZERO GROWTH), LDCS' GROSS DOMESTIC PRODUCT (GDP) INCREASED 5.5 PERCENT IN 1974 (7PERCENT IN LATIN AMERICA) AND SLIPPED ONLY TO ABOUT 4 PERCENT IN 1975 (3 PERCENT IN LATIN AMERICA). IN CONTRAST, PANAMA'S GROWTH RATE DROPPED TO 2.6 PERCENT IN 1974 AND 1.7 PERCENT IN 1975. GROWTH HAD BEGUN TAPERING OFF IN 1971 WHEREAS DURING 1971-73 THE REST OF THE WORLD INCLUDING LATIN AMERICA EXPERIENCED UNPRECEDENTED BOOM.

6. PRIVATE INVESTMENT IN PANAMA REACHED A PEAK IN 1971. GROWTH IN MANUFACTURING BEGAN TO FALL OFF IN 1971 WITH A DECLINE IN THE NUMBER OF ATTRACTIVE IMPORT SUBSTITUTION POSSIBILITIES. LITTLE INCREASE HAS SUBSEQUENTLY TAKEN PLACE IN THE VOLUME OF MANUFACTURED EXPORTS. OUTPUT OF BOTH CONSTRUCTION MATERIALS AND INTERMEDIATE GOODS STOPPED EXPANDING IN 1973. EXPANSION OF CONSTRUCTION ACTIVITY BEGAN SLOWING IN 1972 AND HAS ACTUALLY BEEN DECLINING SINCE 1974. IMPOSITION OF RENT CONTROLS IN 1973 BROUGHT PRIVATE INVESTMENT IN LOW COST HOUSING TO A STANDSTILL. ON THE OTHER HAND, GROWTH OF THE IMPORTANT SERVICES SECTOR REMAINED NEAR 8 PERCENT ANNUALLY THROUGH 1974 (PLUS 3 PERCENT IN 1975) DUE IN PART TO THE MAJOR EXPANSION OF THE FOREIGN BANKING SECTOR SINCE 1971. GROWTH IN AGRICULTURAL OUTPUT HAS REMAINED SLUGGISH SINCE 1970 AT ABOUT 3 PERCENT ANNUALLY, MUCH SLOWER THAN DURING THE 1960'S.

7. PANAMA'S BASIC ECONOMIC WEAKNESS IN OUR VIEW AND THE REASON BEHIND CURRENT STAGNATION IS ITS NON-COMPETITIVENESS IN THE WORLD MARKET--A STRUCTURAL PROBLEM INVOLVING PRIMARILY HIGH COST PRODUCTION (COUPLED WITH A LACK OF RESOURCES) IN BOTH AGRICULTURE AND

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INDUSTRY. THE EXPORT POTENTIAL FOR PANAMANIAN AGRICULTURE IS EXTREMELY LIMITED AT PRESENT. THE MAIN EXPORT, BANANAS, IS IN THE HANDS OF FOREIGN PLANTATION OPERATORS, AND HAS PROBABLY REACHED ITS PEAK IN AN INCREASINGLY COMPETITIVE WORLD MARKET. IN GENERAL, LAND IS OF POOR QUALITY AND FARM LABOR COSTS ARE HIGH--THE \$3 PER DAY MINIMUM WAGE IS ESTIMATED TO BE AT LEAST DOUBLE THE RATE ANYWHERE ELSE IN CENTRAL AMERICA. THE GOVERNMENT ENCOURAGES HIGH COST PRODUCTION, INCLUDING RICE, THE PRINCIPAL CROP, BY SUBSIDIZING PRODUCERS THROUGH SUPPORT PRICES TYPICALLY SET ABOVE THE WORLD MARKET. THUS, PANAMA CANNOT PROFITABLY EXPORT MAJOR CROPS SUCH AS RICE AND CORN AND IS FURTHER PRECLUDED FROM DEVELOPING ANY PROFITABLE EXPORT POTENTIAL FOR VARIOUS LESSER CROPS BY THE SMALL DOMESTIC MARKET BASE IN PANAMA. ACCESSIBLE FORESTS HAVE

BEEN CUT OVER AND THERE IS LITTLE POTENTIAL FOR MEAT
EXPORTS WHILE ACCESS TO THE U.S. MARKET IS RESTRICTED.
PANAMA'S SUGAR INDUSTRY IS LIKEWISE NON-COMPETITIVE DUE TO
HIGH COSTS OF BOTH CANE PRODUCTION AND REFINING OPERATIONS.

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8. AS WITH AGRICULTURE, PANAMA'S MANUFACTURING INDUSTRY
CURRENTLY HAS LITTLE EXPORT OR OVERALL GROWTH POTENTIAL
BECAUSE OF HIGH PRODUCTION COSTS COUPLED WITH A DEARTH OF
NATURAL RESOURCES (COPPER DEPOSITS HAVE NOT YET BEEN
DETERMINED TO BE ECONOMICALLY EXPLOITABLE). MINIMUM WAGES
AND THE GENERAL WAGE AND BENEFIT STRUCTURE IN PANAMA ARE
ESTIMATED TO BE THE HIGHEST IN CENTRAL AMERICA AND AMONG
THE HIGHEST IN ALL LATIN AMERICA. HIGHER WAGES AND BENE-
FITS IN THE CANAL ZONE EXERT UPWARD PRESSURE ON WAGES IN
THE REPUBLIC AS EMPLOYERS COMPETE FOR THE GENERALLY
BETTER QUALIFIED WORKERS ATTRACTED BY ZONE WAGES. THE
DOMINANCE OF THE SERVICE SECTOR IN PANAMA'S CENTRAL URBAN
AREAS WITH ITS HIGHER SKILL LEVELS ALSO CREATES UPWARD
PRESSURE ON THE ENTIRE WAGE AND BENEFIT STRUCTURE. EMPLOYEE
BENEFITS UNDER PANAMA'S LABOR CODE ADD TO DIRECT EMPLOYMENT
COSTS. THE CODE EXERTS INDIRECT PRESSURES ON COSTS THROUGH
RIGIDITIES SUCH AS FIRING RESTRICTIONS IMPOSED ON EMPLOYERS

AND, BY STRENGTHENING THE TRADE UNION MOVEMENT, BOLSTERS THE TREND TOWARD COSTLIER CONTRACT SETTLEMENTS. HIGH LABOR COSTS ENCOURAGE THE SUBSTITUTION OF CAPITAL FOR LABOR, THUS BOOSTING STRUCTURAL UNEMPLOYMENT THROUGHOUT THE ECONOMY. CONFIDENTIAL

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ALSO, RELATIVE CAPITAL COSTS--MOSTLY FOREIGN SOURCED--ARE LIKELY TO RISE AS PANAMA'S ALREADY HIGH DEBT SERVICE BURDEN WORSENS AND THE ECONOMIC OUTLOOK FOR OTHER LDCS IMPROVES RELATIVE TO PANAMA.

9. ESTABLISHING THE BASIS FOR RENEWED GROWTH AND IMPROVED ECONOMIC WELL BEING THAT CAN BE SUSTAINED WILL REQUIRE ACTIONS THAT LEAD TO A LOWER COST STRUCTURE. ONE WIDELY DISCUSSED POSSIBILITY IS AN EASING OF THE LABOR CODE. ALTHOUGH ITS REAL IMPACT ON COSTS REMAINS UNCERTAIN (IT DID NOT BRING ON RECESSION ALTHOUGH IT MAY HAVE STOOD IN THE WAY OF NEEDED PRIVATE SECTOR ADJUSTMENTS), CHANGES PROBABLY WOULD NOT INDUCE AN IMMEDIATE SURGE OF PRIVATE INVESTMENT. HOWEVER, THE BUSINESS COMMUNITY HAS MADE CLEAR ITS CONVICTION THAT CHANGES ARE ESSENTIAL, GIVING THEM AN ADDITIONAL PSYCHOLOGICAL IMPORTANCE THAT BEARS IMPORTANTLY ON THE GENERAL INVESTMENT CLIMATE. CHANGES MIGHT BE A CONVINCING SIGN OF GOP CONCERN OVER THE PRIVATE SECTOR'S ECONOMIC PLIGHT.

10. APPROPRIATE BELT TIGHTENING ALSO COULD INCLUDE LOWERING SUBSIDIES AS WELL AS THE WAGE/BENEFIT STRUCTURE TO REDUCE RELATIVE PRODUCTION COSTS, AND INCREASING PERSONAL TAXES TO CURB CONSUMPTION (PARTICULARLY IMPORTS) AND EXPAND DOMESTIC SAVINGS. THESE EFFECTS ARE USUALLY ACHIEVED INDIRECTLY BY CURRENCY DEVALUATION. SINCE PANAMA'S CURRENCY IS THE U.S. DOLLAR, SUCH ACTIONS MUST BE TAKEN DIRECTLY. IN ADDITION, RESOURCES MAY NEED TO BE MORE HEAVILY CONCENTRATED IN THE INTERNATIONALLY-BASED SERVICES SECTOR WHERE PANAMA HAS MORE NATURAL ADVANTAGES, WITH PROPORTIONATELY LESS IN AGRICULTURE AND THE NON-PRODUCTIVE SOCIAL SECTORS.

11. COMMENTS:

(A) PANAMA'S HIGH WAGES, SUBSIDIES, AND CONSUMER IMPORTS--TOGETHER WITH A MODERATE TAX BURDEN AND LITTLE PUBLIC SAVING--PERMIT A STANDARD OF LIVING WHICH NO LONGER SPEARS TO BE SUPPORTABLE BY PANAMA'S INEFFICIENT DOMESTIC PRODUCTION.

(B) INCREASED EXTERNAL FINANCIAL FLOWS PER SE, REGARDLESS OF CONCESSIONALITY, PERMIT PANAMA TO DEFER GRAPPLING
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WITH THE CORE PROBLEM OF LOW PRODUCTIVITY UNTIL A LATER DATE WHEN THE PROBLEM WILL PROBABLY HAVE WORSENERED, UNLESS SUCH FINANCING BEARS SPECIFICALLY ON SOME ASPECT OF COSTS. INDEED, MUCH OF THE CAPITAL INFLOW OF THE PAST THREE YEARS HAS AGGRAVATED PANAMA'S ECONOMIC MALAISE BY EXACERBATING ITS DEBT SERVICE BURDEN WITHOUT ENHANCING OVERALL PRODUCTIVITY. MOREOVER, TOTAL INFLOWS GREATLY EXCEEDED THE CURRENT ACCOUNT DEFICIT OF PANAMA'S BALANCE OF PAYMENTS, RESULTING IN LARGE NEGATIVE "ERRORS AND OMISSIONS" (AROUND \$100 MILLION ANNUALLY) MOST OF WHICH PROBABLY REPRESENTED OUTFLOWS OF DOMESTICALLY-OWNED CAPITAL.

(C) THE TYPES OF ACTIONS MENTIONED ABOVE FOR ADDRESSING PANAMA'S HIGH COST STRUCTURE RUN HEADLONG INTO THE "REVOLUTION"--THE SOCIAL AND ECONOMIC BENEFITS GRANTED TO THE URBAN AND RURAL WORKING CLASSES OVER THE PAST EIGHT YEARS WHICH WOULD NEED TO BE REVERSED IN PART IN SHORT, THE "REVOLUTION" HAS COLLIDED WITH GROWTH AND ONE OR THE OTHER MUST YIELD. WHETHER OR NOT ACTIONS OF SUFFICIENT SCOPE TO BE ECONOMICALLY MEANINGFUL ALONG THE ABOVE LINES ARE POLITICALLY POSSIBLE FOR THE PRESENT GOVERNMENT IS QUESTIONABLE.

(D) PANAMA'S BEST ECONOMIC PROSPECTS LIE IN THE DEVELOPMENT OF ITS POTENTIAL AS A HUB FOR SERVICING INTERNATIONAL COMMERCE. VARIOUS ASPECTS OF CARGO HANDLING ARE AN ESSENTIAL PART OF THE PICTURE. THUS, THE GOP HAS A VALID CASE IN URGING EARLY ACCESS TO RELEVANT CANAL ZONE SITES NEEDED TO DEVELOP THE INFRASTRUCTURE ON WHICH GROWTH OF VARIOUS TRANSPORT, STORAGE AND OTHER COMMERCIAL SERVICES INDUSTRIES WILL BE BASED.

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